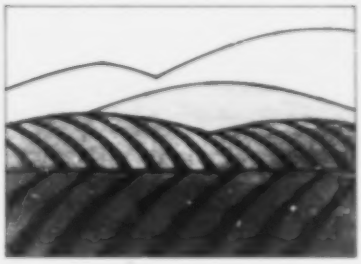
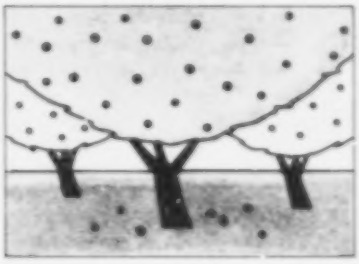
JUNE 1985

CALIFORNIA AGRICULTURE OUTLOOK–1985





Bank of America

A REALISTIC LOOK

In this *California Agriculture Outlook 1985* we take a close look at the current condition of farming in the state and attempt some realistic projections. The key word is "realistic," because a frank assessment of the current situation for the state's farmers requires addressing harsh facts.

Despite the underlying strength of California's agricultural industry, it is currently experiencing its severest financial stress in 50 years. Adjusting for inflation, the state's annual net farm income from 1982 through 1984 was lower than any single year from 1972 through 1981.

Nonetheless, Bank of America is convinced of the industry's inherent strengths and the resilience of most of the state's growers. Indeed, most of our agricultural customers will weather this crisis.

The current situation is often described as an "agricultural credit crisis." That description misses the mark. What we are seeing is an agricultural *profitability* crisis which in turn has spurred a credit crisis. Restore the profit to farming and the credit crisis will fade away.

The agricultural industry is still suffering from the excesses of the 1970s "boom times." Those excesses clearly can be seen today in light of the structural changes in the world economy that began in the early 1980s. These changes include the disinflation of the last three years, high real interest rates, an overly robust dollar, and the increasing self-sufficiency of foreign nations.

By adjusting to these structural changes, we believe the state's agribusiness industry can not only survive, but emerge stronger from the experience.

Bank of America's strategy continues to focus on following five basic principles:

- Sound business decision-making—lending to agriculture as we do to any other business. This includes pricing our agricultural loans at market rates and compensating for risk.
- Good communications—working even closer, on a case-by-case basis, with our customers. This means reassuring the majority of our customers that we want to continue doing business with them, helping some of our customers restructure their debt, or, in the very worst cases, assisting with the orderly liquidation from our portfolio.
- Efficient management tools—providing farmers with products and information to help them manage their business. These include electronic information and management tools, cash management services, and trade finance expertise.
- High quality account officers—developing officers who are good bankers first and who also understand agricultural industries.
- Active governmental liaison—advocating government programs for agriculture at both the state and national level, representing the agricultural industry and the banking community.

Bank of America is serious about its commitment to California's agricultural industry. At the end of 1984, as California's largest private lender to agriculture, Bank of America carried $2.2 billion in its agricultural portfolio. We will continue to support our customers who represent the best in California's agriculture.

Bank of America's interest in the industry is not new. Indeed, it is part of our heritage.

Our bank's founder, A.P. Giannini, recognized the tremendous power and potential of California agriculture. He knew it was what it remains today—a vital part of the state and national economy. He made agricultural lending a

fundamental and substantial part of this bank's business.

We intend to maintain and nourish that traditional relationship by continuing to lend to California agriculture. These loans, prudently allocated by us and well managed by the state's farmers, can have a major impact in maintaining California not only as the nation's largest producer, but one of the largest food producing areas in the world.

Samuel H. Armacost

Samuel H. Armacost
President and
Chief Executive Officer
Bank of America NT&SA

OVERVIEW

California farmers will experience another year of reduced export sales and low commodity prices in 1985. This marks the fifth consecutive year that net farm income will remain below the levels of 1979-1980.

■

Farmers and agribusinesses are making adjustments to their operations in order to remain profitable despite adverse economic conditions. Marketing programs are being enhanced and focused more on domestic markets in order to stimulate demand for farm goods. Planted acreage of most crops has leveled off and fewer acres of permanent crops are being planted, helping to reduce supply levels. Also, farmers are concentrating on new ways to increase efficiency and become low-cost producers of commodities. As supply and demand come back into balance and costs are reduced, profitability will begin to return to much of the state's agricultural industry.

■

The strong U.S. dollar and high interest rates will continue to plague California farmers in 1985. Exports of the state's farm products are likely to remain stagnant at the $3 billion level, well below the record $4.2 billion reached in 1981. However, the dollar is not apt to strengthen further in 1985 and interest rates are not expected to increase. These factors will provide a more stable, if not improved, economic environment for California farmers.

■

Net farm income is forecast to increase only 1.4 percent in 1985 to $3.75 billion. Inflation rates, even at current low levels, will continue to outpace increases in net farm income, resulting in a decline in inflation-adjusted net farm income (see Figure 1). Nevertheless, California will continue to be the number one agricultural state in the nation with $15 billion in cash receipts.

■

Commodity prices will improve in 1985. Fresh vegetable producers will see the strongest markets since they are the least dependent on exports. Cattle producers' incomes should also improve, with prices rising as beef production is reduced later this year.

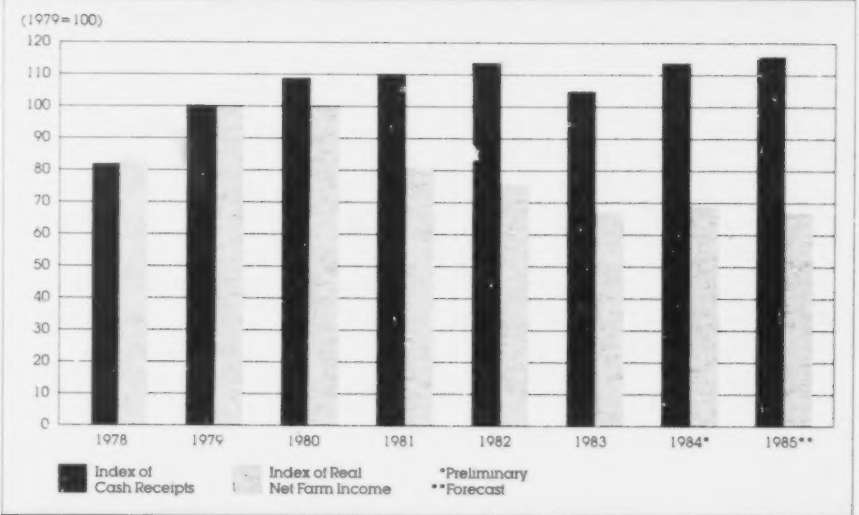
■

In light of the threatened shutoff of water delivery to land draining into the Kesterson Wildlife Refuge earlier this year, disposal of irrigation waste water will be of continuing concern to the state's agricultural industry during 1985. As the productivity of more irrigated land throughout the state is threatened by inadequate drainage, solutions to waste water problems will have to be found.

■

Farm financial stress will be severe for many operations in 1985 and foreclosure and bankruptcy rates will increase, resulting in a reduced number of commercial farmers in California. Operations that are highly leveraged face the most difficulty since their current revenues are not sufficient to cover total costs. Nevertheless, the majority of farms in California are financially sound and will remain profitable.

INDEXES OF CALIFORNIA FARM CASH RECEIPTS AND REAL NET FARM INCOME 1978–1985 — FIGURE 1



EXTERNAL FACTORS

The performance of California's agribusiness industry is increasingly driven by factors outside the control of farm managers. Rising debt levels and expanding exports of farm products during the 1970s made the industry more vulnerable to changes in interest rates and the value of the dollar relative to foreign currencies. Since 1980 the strong dollar and high real interest rates primarily have been responsible for the continuing recession in agriculture.

Economic growth in the United States in 1983 and 1984 and improved economic growth throughout the world have done little to boost farm product sales. Federal legislation, especially the current farm bill, also has been of little help in boosting sales or increasing farm income. In addition to the outlook for interest rates and the value of the dollar, the prospect for changes in federal legislation, especially the 1985 Farm Bill, is a key consideration in determining the outlook for the farm economy.

Budget Deficit: A Continued Drag on Agriculture

Agriculture, along with other trade-sensitive industries, has suffered during the last two years of overall economic growth in the United States. In large part, this is the result of a lopsided federal economic policy. Federal fiscal policy has been expansive, stimulating rapid economic growth. At the same time, federal monetary policy has been tight in an effort to keep inflation under control. These policies have led to economic growth and low inflation rates, but allowed real interest rates (interest rates adjusted for inflation) to remain at historically high levels.

The combination of a strong economy and high real interest rates has attracted foreign capital and strengthened the dollar. Defense and consumer-related industries have expanded rapidly. However, trade-related industries have suffered from the dollar's strength as is evident by the widening trade deficit.

This two-tiered economy is evident from the first quarter 1985 Gross National Product (GNP) figures. Without trade-related industries, GNP growth would have been 4.3 percent. The trade deficit, however, caused GNP growth to be reduced by a full three percentage points to 1.3 percent.

The increasing drag on economic growth caused by trade-related industries is beginning to force policy makers into rekindling efforts to reduce the budget deficit. Although little progress is likely to be made in 1985, increasing concern from Washington over the federal budget deficit, which has resulted in high interest rates and an overly robust dollar, may cause some reductions in the deficit by 1986.

The recent easing of monetary policy, however, is an encouraging sign. Faster money-supply growth should help to reduce any upward pressure on interest rates in the short run and increase economic growth during the second half of 1985. Interest rates are expected to remain within one to two percentage points of their current levels throughout the year.

In addition, for the first time during the decade, the value of the dollar is expected to remain relatively level against foreign currencies. The dollar has weakened somewhat against most major currencies during the first quarter. Although this movement is generally viewed as an adjustment rather than a trend, it does indicate that rates are likely to stabilize this year.

Farm managers should face a more stable, although not improved, economic environment in 1985 than at any time since 1980 despite the lack of progress expected on reducing the federal budget deficit.

1985 Farm Bill— New Directions?

Because of adverse economic and financial conditions faced by many farmers, the role of federal legislation in California agriculture has come under increased scrutiny. Even though California accounts for 10 percent of U.S. farm output, the state's farms have traditionally received only 1 percent to 4 percent of direct federal payments to farmers—the primary recipients are the state's cotton, rice, and dairy farmers.

Producers of the other 200-plus commodities from California farms are largely untouched by federal government support payments and policies. Despite the relatively small use of government programs by California farmers, the severity of the agricultural recession in both California and the nation is roughly equivalent. This situation raises questions as to the effectiveness of government farm programs and as to how tax dollars should be best spent in supporting agriculture.

The Reagan administration is supporting a market-oriented approach to the 1985 Farm Bill—the renewal of the 1933 Agricultural Adjustment Act that occurs every four years. A market-oriented approach is synonymous with a phasing out of government support payments to farmers. The administration is proposing a five-year phase-out, during which time support payments would be gradually reduced. Congressional proposals for the 1985 Farm Bill are also generally "market-oriented" but call for a more gradual phase-out.

If the administration's proposal passes, it will have an immediate impact on California cotton, rice, corn, and wheat farmers. Primarily, the administration's proposal calls for a reduction of the $50,000 limitation on direct payments to growers to $20,000 beginning in 1986. This reduction would make participation in federal farm programs uneconomical for most of the state's farm operations. It would also work to the disadvantage of California farmers compared to farmers in other states because growers on relatively large acreages in California would not be offered the same degree of income protection received by growers in other states on smaller acreages. Also, proposed lower support levels will depress prices for these commodities in the short run.

However, it is unlikely that the administration's proposal will be passed intact. It is possible that without strong support by agricultural groups during the current legislative session, the current legislation will be held over until 1986 as congressional debate continues.

The lack of action on the farm bill is creating uncertainty among California growers. Price support levels established by government programs have an impact on the economic viability of farmland suitable for production of cotton and grain, which accounts for a large share of the cultivated land in California. This, in turn, affects the value of the land and the price buyers are willing to pay for it. Uncertainty over provisions to be incorporated in the farm bill, therefore, may reduce buyers' incentives to purchase farmland, further depressing land prices.

FARM FINANCIAL INDICATORS

California farmers will see only marginal increases in both gross and net farm income in 1985. Gross farm income is expected to be up 3.8 percent to $16.5 billion (see Table 1). However, increased production expenses will offset part of the gain, with farmers' net income increasing only 1.4 percent to $3.75 billion. Net farm income has been stagnant at this relatively low level since 1981, reflecting the troubles currently facing the industry. In fact, after discounting for inflation, net farm income has declined since 1981 and is at the lowest level in over a decade.

Cash receipts from farm marketings, which make up over 90 percent of farm income, will be up only 1.7 percent in 1985 (see Table 2). This increase follows a 9.3 percent increase in 1984 and a 6.5 percent decline in 1983. This volatility was caused mainly by the federal government's Payment-in-Kind (PIK) program. Since 1981 the overall stagnation in cash receipts, especially in relation to inflation, illustrates the continuing recession in agriculture.

Specifically:

- The vegetable sector will continue to show more improvement in cash receipts than other sectors of the farm economy. Vegetables are less dependent on trade than other sectors and are benefiting from U.S. economic growth. Output of vegetables from the state is expected to increase 6.3 percent in terms of value in 1985.
- Fruit and nut cash receipts should be somewhat improved in 1985. However, many producers will continue to experi-

CALIFORNIA FARM INCOME AND EXPENSES 1980–1985 — **TABLE 1**

Year	Cash Receipts (millions)	Percent Change	Gross Farm Income (millions)	Percent Change	Production Expenses (millions)	Percent Change	Net Farm Income (millions)	Percent Change
1980	14003	8.3	14809	9.2	10646	9.6	4163	8.2
1981	14767	1.2	15143	2.2	11426	7.3	3717	-10.7
1982	14429	1.8	15634	3.2	11945	4.5	3689	-0.8
1983	13494	-6.5	14921	-4.6	11500	-3.3	3421	-7.3
1984	14750	9.3	15900	6.6	12200	6.1	3700	8.2
1985	15000	1.7	16500	3.8	12750	4.5	3750	1.4

ence revenues below their total cost of production. Grape growers, in particular, will continue to suffer from low prices.

- The value of field crops is likely to decline in 1985 over 1984 levels, but will remain above the level of cash receipts in 1983. Values for 1984 were inflated by large crop sizes and the lingering impact of improved prices based on the PIK program.
- Livestock receipts will be nearly unchanged in 1985 as improved cattle prices are offset by declining poultry prices. Dairy producers will see incomes stagnate as improved sales volume is offset by reduced federal price support levels.

COMMODITY OUTLOOK: A YEAR OF ADJUSTMENT

Despite the diversity of agricultural commodities produced in California, nearly every sector of the farm industry is suffering from reduced incomes due to low commodity prices. In the past, California appeared immune to the farm recessions that midwestern states experienced. The diversity of the state's crops meant that a price decline for wheat, corn, and rice could be offset by strong markets for almonds and turkeys, with the state's overall farm economy remaining strong.

However, since 1980 a concentration of negative economic factors has forced down the prices of nearly all commodities. This has led to dramatic declines in net farm income and land values. High real interest rates, the strong dollar, and increased foreign agricultural production have primarily contributed to the problems facing the state's agricultural industry. These factors are structural rather than cyclical and unlikely to turn around soon. In response to structural change, operations are being adjusted by farmers in an attempt to become more profitable.

The impact of structural changes and the adjustments being made in response to the changes in four major sectors of California agriculture are presented below.

Interest Rates Reduce Canners' Profits

High real interest rates along with changing consumer tastes have had a negative effect on the state's fruit and vegetable processing industry. Large interest expenditures are characteristic of the industry because of the necessity of financing inventories from the time the food is processed at harvest until it is sold throughout the year.

Higher interest rates have increased processors' costs, but consumers have resisted paying higher prices for processed food. Indeed, the increasing consumer preference for fresh fruit and vegetables in relation to processed foods has been caused in part by the high relative cost of processed foods.

The Consumer Price Index for processed fruits and vegetables increased 24 percent from 1980 to 1984, while the index for fresh fruit and vegetables increased 19 percent. Over this time, consumption of processed fruit and vegetables has declined 2 percent while consumption of fresh fruit and vegetables has increased 6 percent.

Growers of fruit for canning have been the hardest hit by the decline in the processing industry. This is because most fruit-canning facilities in the state are grower-owned cooperatives, resulting in the growers themselves having to absorb the reduced profitability in their canning operations. In addition,

CASH RECEIPTS IN CALIFORNIA 1980–1985

Year	Vegetables (millions)	Percent Change	Fruits and Nuts (millions)	Percent Change	Field Crops (millions)	Percent Change	Horticulture Specialties (millions)	Percent Change
1980	2527	12.5	3059	2.4	3421	28.3	906	12.5
1981	2796	10.6	2954	-3.4	3246	-5.1	940	3.7
1982	2825	1.0	3058	3.5	3123	-3.8	1030	9.6
1983	2981	5.5	2522	-17.5	2858	-8.5	973	-5.5
1984	3200	7.3	2750	9.0	3300	15.5	1050	7.9
1985	3400	6.3	2850	3.6	3150	-4.5	1100	4.7

the drop in consumer demand for canned fruit has reduced prices to growers and forced many to reduce orchard size.

Decreasing acreage has allowed the supply of fruit to match consumption much better. Improvements from this adjustment already have increased the profitability of fruit growers. Since 1981, cling peach-bearing acreage in the state has dropped from 33,780 acres to 27,800 acres.

The value of the state's cling peach crop increased from $43 million in 1982 to an estimated $53 million in 1985, despite the declines in acreage and production. In addition, the marketing effort of cooperatives, proprietary firms, and industry organizations to develop new products and improve marketing, will further increase profitability in the industry.

Strong Dollar Limits Almond Prices

Almonds are one of the state's top cash crops and are consistently among the top three farm commodities exported. During the 1970s, when almond acreage was rapidly expanding, almond growers and their marketing organizations found a ready outlet for their product in foreign markets. Exports also were aided by a continuous decline in the value of the dollar relative to foreign currencies throughout the 1970s.

By 1980 over 60 percent of the ever-expanding California almond crop was being exported. Since 1980, however, the strengthening dollar has reduced the ability of California almond producers to export products at profitable prices. Although the volume of almond export shipments has declined 20 percent since 1980, the price for almonds has dropped even more dramatically from $1.45 to $0.85 per pound to the grower, or more than 40 percent.

This 40 percent decline in the price to the grower has been more than offset by the 60 percent appreciation of the dollar. With increasing prices to foreign buyers, exports of California almonds have declined.

The California almond industry is making two adjustments that will help restore profitability. First, marketing efforts are being redirected toward domestic markets. Increasing the targeting of domestic markets should help boost domestic consumption and sales. By increasing almond sales within the United States, the industry can gain stability.

TABLE 2

All Crops (millions)	Percent Change	Livestock and Livestock Products (millions)	Percent Change	Total Receipts (millions)	Percent Change
9913	13.9	4089	-3.3	14002	8.3
9936	0.2	4231	3.5	14167	1.2
10036	1.0	4393	3.8	14429	1.8
9334	-7.0	4160	-5.3	13494	-6.5
10300	10.3	4450	7.0	14750	9.3
10500	1.9	4500	1.0	15000	1.7

Second, plantings of new almond orchards have slowed. For years the almond industry has been faced with a large amount of nonbearing acreage and the threat of surplus production. Even during the low-income years since 1980, trees planted in the late 1970s and early 1980s have been coming into production, increasing crop size. Now, with fewer new plantings, increased market development both inside and outside the United States will not be offset by increasing domestic production levels.

Increased Chinese Production Upsets Cotton Markets

Cotton is California's most extensively planted row crop and largest farm export, annually accounting for more than 25 percent of total California farm exports. More than 75 percent of California's cotton is exported, primarily to mills in newly industrializing countries in Asia.

Until 1980, cotton exports had been increasing rapidly, especially during the years 1977 to 1980. Chinese imports had been primarily responsible for this export growth. As can be seen in Figure 2, with a rapidly expanding textile industry during this time, Chinese cotton utilization was exceeding production, creating shortages and the need to import. However, beginning in 1980 the Chinese government decided that importing large amounts of cotton was inappropriate for their economy and started giving their farmers strong incentives to plant and produce cotton. By 1983 Chinese growers were producing more cotton than their domestic mills could use.

Successful in this program, the Chinese went from being the world's largest cotton importer in 1980 to being a large net exporter of cotton by

1983. More importantly, increased Chinese production has more than offset reduced production and stock levels in every other nation. Increases in world stock levels have reduced world cotton prices.

Adjustments in world cotton production are likely to come from China and not from California. Producing cotton for export, or to hold as stocks, probably will not be a long-term goal of the Chinese. The Chinese have been attempting to increase exports of manufactured goods, not raw commodities.

Until Chinese cotton production is reduced and comes back into line with domestic use, however, world stocks will remain high, keeping prices low. California growers will need to continue to market their high quality cotton as being superior to the Chinese-grown fiber, and try to realize even larger premium prices from the market.

Foreign Wines Gain Market Share

In addition to reducing farm exports, the increasing strength of the U.S. dollar has increased import competition in the domestic market. The California wine industry's domestic market share has been reduced by foreign wines, in large part, as a result of the increasing strength of the dollar.

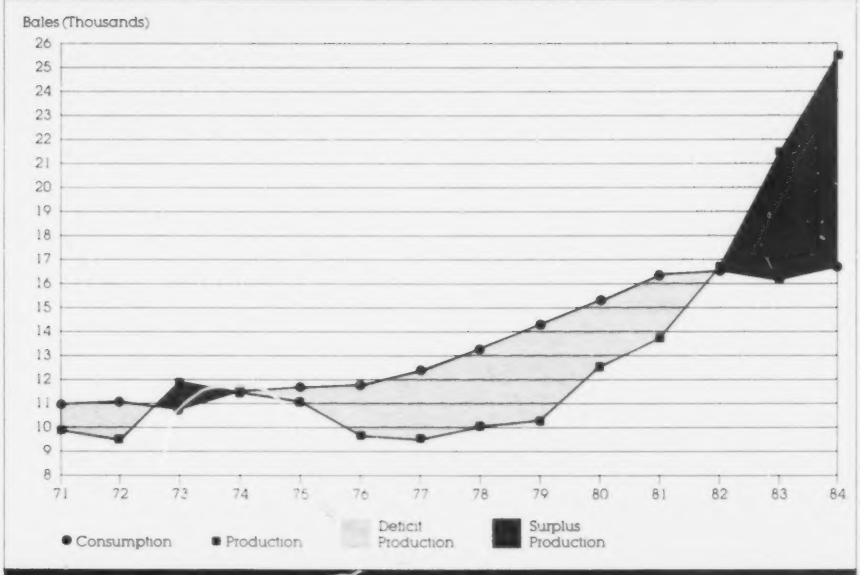
There has been a greater increase in the strength of the dollar relative to the major wine producing countries' currencies than most others. The Italian lira-to-dollar exchange rate has gone from 856:1 in 1980 to 2030:1 currently, and the French franc-to-dollar exchange rate has risen from 4.2:1 to 10.07:1. This means that a French wine that sells in the United States for $3 per bottle today earns a French producer the same number of francs that a sale of a $7.15 bottle of wine would have earned in 1980.

European producers have been able to lower their prices to American consumers steadily during the decade and gain market share. Foreign wines' share of the U.S. market has risen to 25 percent since 1980 from 21 percent, while the market share for California wine has dropped to 66 percent from 69 percent.

The California wine industry's response to increased import competition has been to increase marketing efforts, lobby the administration and Congress for fairer trade agreements, and reduce planting of new grape vines. In addition, planted acreage of some grape varieties has been reduced.

Despite these adjustments, the continuous strengthening of the dollar has caused further erosion of market share. If the value of the dollar does stabilize this year, the progress made in marketing, trade negotiations, and supply reductions should help to stop the erosion of market share as well as improve sales and profitability.

CHINESE COTTON TRENDS 1971–1984 — FIGURE 2



FINANCIAL CONDITIONS IN AGRICULTURE

In recent years many farmers in California have been facing unaccustomed financial stress because of depressed prices for agricultural products. Consequently they are confronted with reduced cash flow, difficulty in servicing debt, lower net income, and diminishing value of assets because of declining prices for farmland.

This has resulted in an increased number of foreclosures. Despite the severity of the problem, it does not extend to all farming operations. The degree of financial difficulties varies significantly not only among farmers producing different com-

(Continued on page 8.)

WATER CONCERNS: A NEW DIMENSION

Water, especially its availability, is always a topic of concern for agricultural interests throughout California. In recent months, however, much of this concern has shifted from the long-term issue of water availability to the problem of disposal of irrigation drainage water.

The immediate cause of this shift in concern was the discovery of high concentrations of selenium, a trace element, in the San Luis Drain and Kesterson Reservoir on the west side of the San Joaquin Valley. High concentrations of selenium have been blamed for the death of a number of water fowl at Kesterson Reservoir.

In March of this year, due to potential charges of possible violations of the Migratory Bird Treaty Act, the U.S. Department of the Interior announced it was shutting down drainage water flowing into the Kesterson Reservoir as well as ending delivery of water to 42,000 acres of farmland that drained agricultural waste water into the reservoir. After considerable discussion and debate, an agreement was reached which allows for continued delivery of irrigation water to these farms in 1985, but imposes a 15-month, phased closure of drainage into the Kesterson Reservoir.

While the immediate crisis has been resolved by allowing farmers in the area affected by the Kesterson closure order to obtain irrigation water and carry out their 1985 farming operations, the underlying problem is far from resolved. By June 1986, Westlands Water District and the farmers operating these 42,000 acres have agreed to develop alternative means of disposal of their waste water and will discontinue discharging drainage into Kesterson.

Irrigated agriculture in dry areas typically requires some type of subsurface drainage to avoid a buildup of salt that reduces the productivity of the land. Consequently, the drainage of subsurface water and the availability of water and its use are closely related matters.

The drainage problem in the San Joaquin Valley comes as no surprise to those who have followed California water issues. The San Luis Drain was authorized by Congress in 1960 to carry drainage water from the west side of the San Joaquin Valley and discharge the water into the western Sacramento-San Joaquin delta. However, with less than half of the drain constructed, its completion was stalled by funding restrictions and environmental concerns.

Possible Disposal Alternatives

Four basic alternatives for disposing of agricultural drainage water on the west side of the San Joaquin Valley are being studied: establishment of evaporation ponds within the district; on-farm recycling of drainage water by blending it with fresh water and using the blended water for irrigation within the district; recycling of drainage water to irrigate salt-tolerant crops; or a combination of the above.

It is obvious, however, that each proposal would likely result in increased costs to farmers at a time when profit margins in farming already are depressed.

Although the problems of Kesterson Reservoir and the agricultural waste water disposal on the west side of the San Joaquin Valley are the immediate concern, the implications of Kesterson are widespread. It seems likely that Kesterson is only a harbinger of a condition that ultimately will involve other irrigated agricultural areas in California as well as other western states.

A Long-Range Threat

In the Central Valley alone, it is estimated that subsurface drainage water must be removed from 1.2 million acres of irrigated farmland to keep the land productive. Unless a means for disposing of agricultural waste water can be found that is environmentally and economically acceptable, the long-range economic future of irrigated land with subsurface drainage problems, both in California and other Western states, is threatened.

In a broader context, disposal of agricultural waste water is only part of an overall problem with the management and disposal of toxic waste. Means of dealing with the broader problem are currently being investigated at both state and federal levels.

The state's agricultural community should be intensely following not only the Kesterson problem, but also the broader problem of toxic waste. It appears that all areas of the state ultimately will be affected by solutions adopted at Kesterson, as well as by legislation developed to regulate toxic waste disposal.

modities in the state's highly diverse agricultural industry, but also among farmers producing the same commodity.

Net operating margins (revenue from sale of products less direct production costs) for a majority of California agricultural products have declined in recent years. Even for products with positive operating margins, those margins are not sufficient to cover the total costs of farming operations. Consequently, the most critical aspect of the current farm financial crisis is that although many farmers are able to cover the direct costs involved with production of crops and livestock, they are not able to generate sufficient income to cover total costs. A large proportion of these costs are debts carried over from previous years for equipment, and real estate debt service obligations incurred in the past (Figure 3).

Since returns are sufficient to cover direct production costs, producers have an incentive to keep land in agricultural use. As a result, production levels are being maintained, preventing improvement of product prices and operating margins through reduced output.

The Problem—Sown in the 1970s

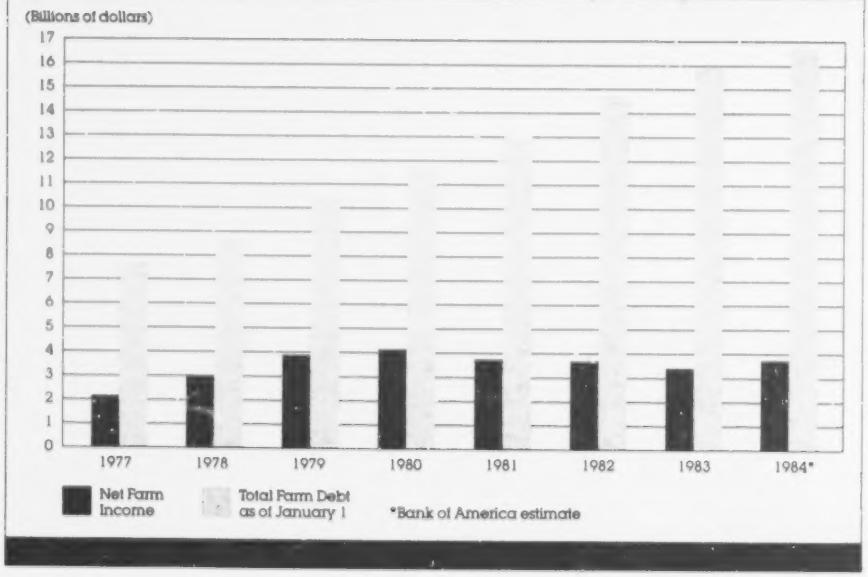
In general, the farmers having the greatest financial difficulty are those who expanded their operations during the late 1970s by going further in debt in order to acquire more farm real estate. At the national level, those farmers facing the most severe financial difficulties are those whose debts exceed 40 percent of total assets.

The late 1970s was a period of rapid expansion of farm exports and rising farm incomes. These conditions, coupled with high inflation and low real interest rates, encouraged farmers to expand their operations by purchasing more farmland with borrowed money. As a result, during this period there was a large increase in the proportion of debt to assets for many farmers, as well as a rising proportion of interest expense to total production costs.

The increased demand for agricultural real estate, both from farmers as well as other investors who perceived farmland as an attractive investment and possible tax shelter, caused a boom in California farmland values. During the 1978-81 period, farmland values increased at an average annual rate of 23 percent.

In many cases, however, the higher farmland values could not be justified by a strict analysis of the income that the land could be expected to produce at then-current commodity prices. This result was most pronounced for land devoted to production of annual crops as compared with land in permanent plantings of trees and vines. Prices paid by buyers were rationalized on one of two grounds: land prices would escalate further, providing capital gains; or the value of land purchased, combined with value of land already owned, would average out to be a reasonable purchase price and a tolerable debt level when the total holdings of agricultural real estate were considered.

CALIFORNIA FARM INCOME AND TOTAL FARM DEBT 1977–1984 — FIGURE 3



Falling Prices in the 1980s

When prices for many agricultural products fell in the early 1980s, farmland prices abruptly stopped appreciating and started falling. This decline in farmland values began to erode farmers' net worth. With a reduced net worth, many farmers' ability to use their farmland assets as a basis for increased borrowing capacity was lowered and for some farmers, eliminated.

Historically, farmers have used rising real estate asset values to support increased borrowings to meet production

financing needs. With agricultural real estate values stable or declining, this basis of support for obtaining production financing began evaporating. Also, some farmers who had already increased their borrowing based on appreciated real estate values found themselves with loan balances exceeding the value of their farmland that in the past had so faithfully served them as collateral.

For highly leveraged farmers, all these converging problems have resulted in a reduction in cash flow, making it difficult, if not impossible, for them to meet their real estate mortgage payments. In addition, the decline in real estate values has resulted in lenders and their regulators becoming increasingly concerned over the quality of many loans and the ability of borrowers to meet loan payments. As a consequence, many of those farmers who are experiencing financial difficulties are trying to sell some land in order to reduce their total debt and debt-service obligations. Unfortunately for potential sellers, the reduced profitability of owning farmland coupled with the increased quantities of land available for sale, is causing land prices to continue falling.

The generally accepted belief that an era of rapidly rising farmland values has ended and future growth in land values will be slow has further diminished farm real estate values. Faced with these circumstances, some owners of farmland, especially corporate owners, have sold farmland and put the money in more promising assets. Additional amounts of farmland have been placed on the market by financial institutions that have had to foreclose on the land.

With farmland prices still in decline, buyers seem to be standing in the wings waiting for prices to reach their bottom before acting. Later in the year prices should begin to stabilize at levels justified by the income that can be realized from farming at today's product prices. The number of farm real estate sales should then begin to increase.

EXPANDING APPLE ACREAGE IN CALIFORNIA

Despite the current financial squeeze in agriculture, investors continue to develop California land to raise specialty crops. One of the most recent additions to California farmland is the Granny Smith apple tree. Nearly 4,000 acres of Granny Smith apples have been planted in the state since 1980 when 1,000 acres were planted. Already the Granny Smith variety accounts for nearly one-fifth of the total apple acreage in the state. However, since apple trees take two to three years to come into production, over half the Granny Smith acreage planted is nonbearing.

Increased investment in apple orchards in the state followed increasing consumer demand for Granny Smith apples. Although not a new variety, consumers have chosen the green, firm, slightly tart apple as a suitable alternative to the softer, sweeter, red apples that predominate American markets. Most Granny Smith apples are imported primarily from France and New Zealand.

Imported apples have sold well in supermarkets despite premium prices. Apple producers in this country, seeing this phenomenon, decided that domestically grown Granny Smiths should also draw premium prices over other varieties. Increased numbers of Granny Smith apple trees are being planted in most apple-producing states.

California is especially well-suited climatically to produce Granny Smith apples. Apple production in the state had declined in recent years because the popular red apples need a colder climate, such as is available in Washington State. However, Granny Smith apples are expected to do better in California than in Washington because of the longer growing season and warmer temperature here.

Although market acceptance of California Granny Smith apples is still unknown, climatically the state should be able to produce the same quality apple as is available from New Zealand. Different harvesting seasons make it possible for California producers to develop a complementary marketing program.

A Recapitalization of Agriculture

What we are seeing, not just in California but throughout the United States, is a recapitalization of agriculture: owners are selling off land that has steadily declined in value in recent years and new owners are acquiring it at a lower price that is more in line with its potential for profit. This recapitalization will probably continue over the next two to three years as farmland continues to change hands.

Ultimately, as conditions in the farm real estate market stabilize, significant changes in ownership of farmland will have occurred, with the new owners having a considerably different cost structure than did previous owners, especially those who

acquired farmland at the peak values during the late 1970s.

The great majority of California farmers are economically viable, even with current depressed profit margins, and will be able to continue in farming. Some of the state's financially troubled farmers likely will be able to continue operating by restructuring debt to permit them to work through their current difficulties.

However, other farmers may not be able to continue operating and obtain funds for financing ongoing operations unless some form of assistance is provided through government programs. It appears, however, that a number of farmers will be unable to continue in farming, since their financial condition precludes any form of assistance that could make it feasible for them to obtain funding for continued operations. Without a doubt, a shakeout is occurring among California's commercial farmers.

Rapid increases in prices for agricultural products are not anticipated in 1985. Consequently, profit margins and cash flow from farming operations during 1985 are not expected to improve greatly and will continue to result in financial stress for many farmers.

The Way Out—Good Management Is a Key

In the economic environment expected for agriculture over the next few years, it will be even more important for farmers to continue to stress marketing as well as effective production and financial management. Good management information and records on which to base production and financial decisions will be essential to ensure that production costs are minimized.

With the deterioration of their net worth, farmers have less of a financial cushion than they formerly did. Consequently, risk management should be given high priority. Techniques available include federal crop insurance, forward contracting, hedging, and crop diversification.

Over the long term, management is the factor that will mark the difference between those who are able to continue farming and those who will be forced to quit. However, there is a limit to how much effective management can do for those operations that are having severe financial problems as a result of high leverage. Survival in farming requires that debt be reduced to workable levels. Then, and only then, can good management again be an effective component of a successful farm operation.

Overall, California's agricultural industry is in an adjustment period. Adjustment is occurring in the structure of farm ownership, real estate values, and profit margins. This adjustment process is expected to continue for at least the next one to three years. During this time, no significant improvement is expected in commodity prices that would result in sharply improved operating results.

For many farmers, this means a continued period of financial stress. The adjustments currently being made, in the long run, have a good chance of setting the stage for a return to moderate profitability. However, the large capital gains in farm real estate that were experienced during the late 1970s cannot be expected in the foreseeable future.

Bank of America, as the nation's largest commercial bank lender to agriculture, provides a complete package of financial services to farmers and other agribusiness participants. These services include the financing of crop and livestock production, farm real estate and improvements, as well as financing operations of feedlots, co-ops, processors, and dealers. It also provides commodity loans, equipment financing and leasing, trade and margin financing, appraisal, and trust services and farm management. For crop-production loan customers, Bank of America offers a computer-assisted financial service. This service covers all related aspects of financial management and planning for farmers, and allows them to monitor their progress against projections and goals.

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